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SUBJECT: CYPRUS: Relatively Gloomy Economic Outlook

REF: NICOSIA 594

(U) This cable is sensitive but unclassified. Please protect accordingly.

¶1. (SBU) Summary. Cyprus was late entering its current recession and it will be late exiting it. Underlying structural problems (such as rigidities in the labor market - including exceptionally strong unions and a blanket wage indexation system - along with a large and extremely well-compensated civil service) have much more to do with Cyprus' current state of affairs than the global crisis which served as the trigger. Whether the government will be able to use this crisis to introduce some much-needed changes or just wait for the global economic climate to improve and hope for the best will be a major factor for the country's medium term outlook. End Summary.

Economic Outlook by the Numbers

¶2. (U) While many countries are beginning to witness encouraging signs that the worst of the global financial crisis has passed, Cyprus seems far from a recovery. The economy has been recording negative growth rates since the last quarter of 2008 - later than most economies - and is expected to close 2009 with a year-on-year contraction of up to 1.3 percent. In Q3, the economy shrank 2 percent, as most other EU economies began to emerge from recession. Growth in 2010 is expected to be only marginally positive for both Cyprus and the rest of the EU (between 0.1 and 0.5 percent for Cyprus, and around 0.7 percent for the EU 27 as a whole).

¶3. (U) The numbers for the first three quarters of 2009 indicate the slowdown here accelerated throughout the year but conditions should not continue to deteriorate much more. Credit expansion in 3Q 2009 dropped to 6.9 percent - the lowest since November 2006 and appreciably less than the 24.6 percent recorded a year earlier. The current account deficit reached 9 percent in the first half of 2009, still high but considerably better than last year's record-setting 17.7 percent, which was abetted by exceptionally strong consumer demand for luxury imports.

¶4. (U) During January-October 2009, tourism arrivals recorded a reduction of 11.1 percent, while tourism revenue (responsible for 11 percent of GDP) was down 16.7 percent. Property sales in 2009 were 50 percent of those in the previous year, reflecting a complete absence of foreign buyers. Property prices in Nicosia and Limassol have held up surprisingly well, propped up by domestic demand. However, property prices in areas relying heavily on foreign demand, like Paphos and Ayia Napa/Protaras, fell by as much 30 percent.

¶5. (U) Unemployment reached 6.0 percent of the labor force in October 2009, from 3.6 percent a year earlier. Although still lower than the average for the Eurozone countries (9.7 percent), Cyprus has not seen unemployment this high since 1976, when the Cypriot economy was still picking up the pieces from the 1974 events.

¶6. (U) Inflation has slowed considerably during 2009 and is expected to reach 0.2 percent for the year, from 4.7 in 2008, largely on account of reduced international oil prices. In 2010, inflation is expected to rebound to 2.6 percent.

Public Finances Deteriorate

¶7. (SBU) Public finances deteriorated significantly over the past year. When the Christofias administration came to power less than two years ago, it inherited a fiscal surplus of 3.4 percent. This surplus shrank to 0.9 percent in 2008, and swung into deficit in ¶2009. Until recently, the GOC claimed it would keep the deficit below 3.0 percent. The Central Bank projects the deficit will reach 3.5 percent in 2009 (possibly worse), and 5.7 percent in 2010. If this scenario is realized, Cyprus will be placed under Brussels' supervision, in accordance with the EU's Excessive Deficit Procedure (EDP). Five other EU countries (Greece, Malta, Ireland, Spain, and France) have already been placed under EDP supervision this year. Another eight EU countries (Cyprus' fellow Eurozone members Germany, Austria, Belgium, the Netherlands, Portugal, Slovenia, and Slovakia -- along with the Czech Republic, which is outside the Eurozone) may also be placed under EDP supervision. Cypriots are concerned that, apart from losing face, being subject to EDP will mean increasingly strict public oversight regarding its budget, and more expensive foreign borrowing as the country risks a downgrade of its sovereign credit ratings if the deficits continue to mount.

¶8. (SBU) Almost all of our business and economic sector interlocutors (including government economists) are incredulous that the government failed to plan for the rapid economic downturn. They argue that instead of predicting the deterioration in public finances and working towards its amelioration, the government contributed to the problem by creating 1,100 new positions within an already bloated civil service. During the recent Annual General Meeting of the politically powerful Cyprus Chamber of Commerce and Industry its chief, Manthos Mavrommatis, sternly called on the government (with President Christofias sitting in the front row) to reign in its payroll, citing the following figures: from 1990 to 2009, the number of civil servants mushroomed from 33,978 to 51,787, while the civil service payroll exploded from Euros 372 million to Euros 2 billion.) Quarter after quarter over the past year, Finance Minister Stavrakis kept revising his estimate for the deficit, costing him much credibility. Instead of heeding the advice of Central Bank Governor Orphanides, who had warned about deteriorating public finances last year, Stavrakis chose to publicly differ with the conservative outlook of Central Bank, as well as the IMF, which he publicly disparaged.

Stavrakis Kicks Off Discussion on Major Changes
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¶9. (SBU) More than the immediate problem of returning to growth, what disturbs analysts here (as well as the IMF in a June 2009 report) are long-term problems:

-- Return to growth in two of Cyprus' main economic pillars, construction/real estate and tourism, seems unlikely anytime soon.

-- Structural inefficiencies in the economy (especially a bloated civil service, automatic cost-of-living adjustments, and high level of transfer payments) make Cyprus less competitive than many competing economies.

-- Following often ill-advised government policies, e.g. locking increases in future government spending (by hiring civil servants and increasing pension payments), while cutting back on spending that would generate current economic activity or improve the economic infrastructure.

¶10. (SBU) Minister Stavrakis now seems to be embracing the need to address these difficult issues. Seeking to minimize the political fallout, he called a meeting with political leaders on November 30 to seek their views and make proposals on how to improve public finances. Stavrakis submitted five ideas aimed at cutting the civil service payroll. His suggestions (radical by Cypriot standards) provided:

-- Zero pay increases for civil servants (without specifying the duration);

-- Reducing wages for new incoming civil servants;

-- Trimming the size of the civil service by as much as 3 percent annually, entirely through attrition;

-- Having new civil service employees contribute to their pension funds (unlike existing employees who make no payments into their pension fund);

-- Limiting overtime (by introducing a "ceiling" on the number of overtime hours).

¶11. (SBU) After the meeting, Stavrakis said everyone recognized the existence of "an ongoing structural problem with the public finances of Cyprus, with state expenditure increasing at a faster rate than revenue, causing a long-term, structural budgetary problem." Outside of the meeting, Stavrakis focused on discussing ways to increase the rate of tax collection (without increasing tax rates). He accused wealthy doctors and lawyers of evading taxes which, if collected, Stavrakis claims would go a long way towards solving the budget problems.

¶12. (SBU) Stavrakis also used the meeting to sound out political party leaders about amending the Cost of Living Allowance (COLA). COLA has been a long-standing institution in Cyprus, providing employees across the board with wage increases twice a year to compensate for inflation. Many economists, including from the IMF, have called for its amendment or abolition over the years, only to encounter vehement opposition from local unions. If nothing else, the current economic climate has convinced three major parties (including communist AKEL) that the time has come for a dialog on amending COLA. One idea currently being considered is to introduce a tiered COLA, thereby maintaining full wage indexation only for lower-wage employees, and reducing it further up the income scale. In previous years, AKEL refused to discuss any change to the COLA.

Greek Downgrade Sends Ripples Through Cypriot Banks
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¶13. (SBU) Despite a slight rise in domestic non-performing loans and slow loan growth, the Cypriot banking system appears sound with adequate reserves and capital. However, Cypriot banks, with their large exposure to the Greek market through their Greek branch systems, are watching recent developments in that country anxiously in the wake of the downgrading of Greek risk. In addition to growing bad loans from their Greek customers, Cypriot banks will have to write down the value of Greek bonds held in their portfolios, with a corresponding hit to bank profitability.

¶14. (SBU) The Greek downgrade also dashes hopes for interest rate reductions in Cyprus. Domestic rates remain stubbornly above those in most of the rest of the Eurozone by as much as 200 basis points. This is due, in large part, to Greek bank branches in Cyprus aggressively trying to attract local deposits to help fund their parent companies. The recent GOC decision to issue three-year bonds valued at Euro 3 billion to increase liquidity and drive rates down was a welcome, albeit belated, response to tightening liquidity in Cyprus.

¶15. (SBU) Comment: While Cyprus entered its current recession on the heels of the global crisis, getting out will have much more to do with addressing Cyprus' long-standing, underlying structural problems than with global conditions. In many ways, Cyprus is at an economic crossroads. There is a growing realization among politicians and the public that past models will not work in the future - there is no longer a currency that can be used to gain competitiveness and EU rules limit other tools that in the past could have been utilized. Tourism has limited potential as an economic driver and the island has priced itself out of the EU real estate game. The financial services sector continues to be a bright spot but it, too, is under some strain as labor costs rise. In short, the Cypriot economy may need to re-invent itself. End Comment.